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Regional Technical Coordinator
Midwest Region

Assistant Chief Counsel (Income Tax and Accounting)
CC:IT&A:4 TCR 17,915

Technical Coordination Report Submitted by:
Mr. Lanny R. Lobdell
Springfield District

Recommending: Eliminating Section 6694(a)(3) of the Internal Revenue Code.

Mr. Lobdell suggests that the criteria for the penalty under section 6694(a) of the Internal Revenue Code be revised. Under section 6694(a), an income tax return preparer who causes an understatement of tax must pay a penalty of \$250, unless the preparer shows reasonable cause for the understatement and that he or she acted in good faith. The return preparer penalty applies only if three conditions are met. First, any part of any understatement of tax on a return or claim for refund was due to a position that had no realistic possibility of being sustained on its merits (section 6694(a)(1)). Second, the income tax return preparer for the return or claim knew or reasonably should have known of the position (section 6694(a)(2)). Finally, the position was not disclosed as provided in section 6662(d)(2)(B)(ii) or was frivolous (section 6694(a)(3)). Mr. Lobdell proposes the elimination of this last standard.

Mr. Lobdell supports his position by referring to the recent examination of a certified public accountant who took four positions that, in Mr. Lobdell's opinion, had no realistic possibility of being sustained on their merits. Mr. Lobdell relates that Rev. Proc. 90-16, 1990-1 C.B. 477, which provides guidance in determining when disclosure is adequate under section 6662(d) of the Code, prevented the Internal Revenue Service from imposing the return preparer penalty. In the case described by Mr. Lobdell, the return preparer met the disclosure standard of the revenue procedure on three of the four positions taken, so Mr. Lobdell and his group manager decided that the return preparer penalty should not be asserted. Consistent with his proposal to eliminate section 6694(a)(3), Mr. Lobdell urges that the disclosure standards of Rev. Proc. 90-16 not be applied to protect return preparers from being penalized under section 6694(a).

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As Mr. Lobdell indicates in his technical coordination report, the exception to the return preparer penalty for adequate disclosure of nonfrivolous positions was added by the Omnibus Budget Reconciliation Act of 1989, section 7732(a), 1990-1 C.B. 210, 266. Eliminating this exception would, of course, require congressional action. Such action is unlikely in the near future. The proposed Income Tax Regulations under section 6694 of the Code follow the statute by providing a safe harbor for return preparers who make adequate disclosure. Section 1.6694-2(c)(3) of the proposed Income Tax Regulations published in the Federal Register on March 4, 1991 (56 F.R. 8959), 1991-13 I.R.B. 41, 46, proscribes imposition of the section 6694(a) penalty where a nonfrivolous position is disclosed in accordance with the annual revenue procedure prescribing the circumstances under which disclosure is adequate. As mentioned, taxpayers who make disclosure in accordance with this same revenue procedure are insulated from the substantial understatement penalty.

We believe that applying Rev. Proc. 90-16 (which was updated by Rev. Proc. 91-19, 1991-10 I.R.B. 24) to the return preparer penalty effectuates congressional intent not to impose the return preparer penalty where a nonfrivolous position is adequately disclosed. We accordingly believe that the section 6694(a) penalty should not be imposed where a return preparer makes disclosure of a nonfrivolous position in accordance with the revenue procedure (or its successors).

We are grateful for Mr. Lobdell's initiative in submitting his report and hope that he will continue to provide us with his ideas. We are forwarding a copy of Mr. Lobdell's report to the Penalty Handbook Task Force, which may find the circumstances he describes useful in preparing examples for the upcoming handbook. We have attached copies of this memorandum for the District Technical Coordinator, Mr. Lobdell, and other interested persons.

Assistant Chief Counsel (Income Tax &
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~~George Baker~~

By _____
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